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C O N F I D E N T I A L SECTION 01 OF 03 TAIPEI 003738

SIPDIS

STATE PLEASE PASS AIT/W AND USTR
STATE FOR EAP/RSP/TC, EAP/EP AND EB/IFD/OMA
USTR FOR SCOTT KI
USDOC FOR 4420/USFCS/OEEA/EAP/LDROKER
USDOC FOR 3132/USFCS/OIO/EAP/ADAVENPORT
TREASURY FOR OASIA/ZELIKOW AND WISNER
TREASURY PLEASE PASS TO OCC/AMCMAHON
TREASURY ALSO PASS TO FEDERAL RESERVE/BOARD OF GOVERNORS,
AND SAN FRANCISCO FRB/TERESA CURRAN

E.O. 12958: DECL: 11/11/2024

TAGS: EFIN EINV ECON TW

SUBJECT: TAIWAN CURRENCY APPRECIATION

Classified By: AIT Director Douglas Paal, Reason 1.4 (B/D)

11. (C) Summary: On November 22, Taiwan's Central Bank of China (CBC) intervened in foreign exchange markets to slow the ongoing appreciation of the New Taiwan Dollar (NTD) after the currency reached its highest levels in almost four years.

Speculators are moving additional foreign capital to Taiwan in anticipation of further declines in the USD. A CBC official told AIT that despite the weak USD, Taiwan would continue to keep most of its foreign exchange reserves in USD denominated assets, placing safety and liquidity ahead of profit. End summary.

Cause and Effect of the Rising NTD

12. (C) Taiwan CBC officials have confirmed to AIT that they intervened in currency markets on November 22 to slow the rise of the NTD. They claim the intervention was slight, less than one percent of market volume. The NTD opened on November 23 at NTD 32.495 per USD after CBC intervention, slightly down from its 44-month high close of NTD 32.420 per USD on November 18. The value of the New Taiwan Dollar (NTD) in USD terms has risen sharply in recent weeks, gaining more than 4 percent on the USD since late September. However, the Korean Won has gained more against the USD in recent weeks than has the NTD, and the Japanese Yen has also gained about four percent.

13. (C) The ongoing appreciation of Asian currencies and an announcement by Morgan Stanley that it will increase the weighting of Taiwan share prices in its international capital index have attracted foreign capital to Taiwan. Foreign net purchases of Taiwan's traded stocks have already reached NTD 200 billion this year. The widening U.S. trade and Federal fiscal deficits, and widespread anticipation of a loosened trading band for China's Renminbi has fueled speculation of continued declines in the value of the USD. The impact on the competitiveness of Taiwan companies will be closely linked to exchange rates in Japan and South Korea, where Taiwan's main commercial rivals are located.

14. (C) Until November 22, CBC claimed it had made no significant effort to check the NTD appreciation. However, CBC officials admitted to AIT that they routinely "manage" foreign exchange reserves to avoid losses. In an indication of some tolerance for NTD appreciation, CBC officials noted to AIT that currency appreciation is an effective way to fight import-led inflation and Taiwan was among the first Asian economies to follow the U.S. Federal Reserve in raising interest rates (CBC raised Taiwan's discount rate by 0.25 percent on September 30).

The Middle Way

15. (C) The criteria used by CBC to manage the NTD exchange rates are closely guarded. However, some AIT financial sector contacts believe that changes in the value of the NTD closely follow fluctuations in the USD-Yen exchange rate, and that the NTD keeps to an average value between the two currencies; i.e., the NTD usually gains or loses value in concert with the Yen's gains or losses against the USD. In addition, many Taiwan companies involved in international trade have reportedly already taken action to hedge against this risk, as they have been urged to do by Taiwan's Minister of Economics. On November 8, when the NTD reached a six month high of 32.89 per USD, Minister Ho tried to reassure the business community by saying the NTD appreciation thus far would not have a significant negative impact on Taiwan's external trade. The relative stability of the NTD exchange rate against the USD is viewed as a positive factor by the business community.

16. (C) While local economists predict some impact on Taiwan's exports to the United States, appreciation in the

current 4 percent range is seen as tolerable. However, several Taiwan industry associations have openly called for CBC to intervene to slow the NTD's "too rapid" rise, and with legislative elections scheduled for December 11, the NTD appreciation is a sensitive political issue. On November 20, the Vice Minister of Economic Affairs urged Taiwan manufacturers to speed up the globalization of their business operations to reduce the impact of currency fluctuations. There will be additional upward pressure on the NTD at the end of the month, when exporters often sell off their USD receipts.

U.S. Election Profitable for Central Bank

17. (C) CBC Foreign Exchange Department Director General George Chou told AIT that CBC's Foreign Exchange Trading team monitors global foreign exchange markets well beyond regular office hours. In spite of the 13-hour time difference some team members are assigned to monitor trading activity in New York. Chou receives updates on U.S. market trends, farm reports, payroll figures, and other financial reports well into the night. Chou mentioned that on the night of the U.S. presidential election, his foreign exchange trading team earned USD 300,000 from management of CBC's assets in foreign markets and capitalizing on USD fluctuations during the ballot counting.

CBC Will Continue to Hold USG Bonds

18. (C) In general, Chou said, Taiwan's CBC follows three principles in managing its foreign exchange reserves: safety, liquidity, and profitability, with safety and liquidity the priorities. When international situations pose a threat to the safety of Taiwan's foreign exchange reserves, CBC will take defensive action, including moving assets out of a region. To illustrate this point, Chou mentioned that CBC stopped including Hong Kong dollars in its foreign exchange portfolio after Hong Kong's retrocession to China, since this made Hong Kong less secure, from Taiwan's point of view. It is with safety foremost in mind that CBC will continue to hold a large percentage of its assets in U.S. Government bonds, and to keep large bank deposits in the United States. While the exact ratios of foreign currencies in Taiwan's portfolio of USD 235 billion (as of September 2004) in foreign exchange reserves is considered confidential information, local economists believe it is roughly USD 65%, Euro 20%, and Japanese Yen 15%.

Other Factors Influencing the NTD

19. (C) Chou mentioned that another factor affecting the composition of CBC's foreign exchange reserves is interest rates. The U.S. Fed's raising interest rates reinforces CBC's intent to keep its deposits in U.S. banking institutions. However, it is also widely believed that over the past two years CBC has increased its holdings of Euros to take advantage of their appreciation trend. The PRC's recent raising of interest rates for the first time in nine years and new lending restrictions designed to cool economic growth are expected to result in an increased outflow of capital from Taiwan to China Mainland as PRC-based Taiwan companies turn to Taiwan financial institutions for cheaper working capital. The capital inflow into Taiwan precipitated by the Morgan Stanley weighting increase is seen as short term. As the net inflow of capital lessens in coming months, this source of pressure on the NTD to appreciate will also lessen. However, Taiwan's relatively high growth rates compared with other Asian economies, and close economic relations with China still make the NTD an attractive target for speculators.

Contradictory Goals

110. (C) Comment: There will always be tradeoffs among CBC goals of safety, liquidity, and profitability for Taiwan's foreign exchange reserves. Even a small percentage decline in the value of Taiwan's USD 235 billion foreign exchange reserve translates into an enormous loss. In spite of Chou's assurances that Taiwan will keep the bulk of its foreign exchange reserves in USD denominated assets, as a banker conditioned to minimize risk and maximize profit, he will surely face strong pressure to protect against the loss of value that would result from further declines in the USD. From a purely economic point of view the NTD appreciation thus far will have only a minor impact on Taiwan's external trade, especially given the even greater appreciation in the currencies of other economies. Under the additional pressure of loud opposition from local businesses to the rapid NTD appreciation, CBC has opted to slow the NTD's rise prior to the December 11 elections. There is likely to be continued upward pressure on the NTD in coming weeks. End comment.